Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

By Bill O'Grady

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Wallonia versus Flanders

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On Nov. 5, Belgium surpassed its previous record, set in 1987, for a party failing to form a government. Elections were held on June 10, and to date, the winning Christian Democrats have been unable to form a governing coalition. The problem is that Belgium is linguistically divided, which works against the compromises required to form governments. The current crisis threatens Belgium's existence.

In this report, we will discuss the history of the country and the importance of the linguistic and cultural divide to the current crisis. We will also examine the chances of a breakup, the broader issues a breakup would bring, why the resolution of this crisis is important and the potential financial market ramifications.

Belgium's History: The Linguistic and Cultural Divide

Belgium declared its independence in 1830 in the aftermath of the Belgium Revolution. The region became part of the United Kingdom of the Netherlands in the wake of the Napoleonic Wars. However, the Walloons, French-speaking Catholics in the southern part of the country, felt particularly oppressed by the Calvinist Dutch. Even the Belgium Dutch, known as the Flemish, were mostly Catholic and resented the Calvinist king of the Netherlands. European powers were generally divided on creating Belgium; the French, still smarting from the post-Napoleon losses, supported the creation of the new state, but other nations were opposed, fearing the French would annex Wallonia. Eventually, most of these nations decided to go along with the new nation, seeing it as primarily a buffer state between France and the Netherlands.

The Walloons, although a minority in the new nation, dominated the political system. The French-speaking Walloons treated the Dutch-speaking Flemish as second-class citizens. The Walloons made French the language of government, and education denied the Flemish the right to teach their children in their native language. During World War I, the Belgium army's office corps was primarily French-speaking, whereas the non-officers were Flemish. Not only did Walloon officers order thousands of Flemish soldiers to march to their deaths, some of the orders were misunderstood because of the language differences. Needless to say, these events led to significant Flemish resentment.

Into the 1960s, Wallonia provided most of Belgium's economic growth as its coal and steel industries supported European rebuilding and expansion. However, since then, rising competition has sent this region into decline; at the same time, Flanders, with its robust technology and trade sector, has become the most economically viable region. Currently, unemployment is running 5% in Flanders and 14% in Wallonia. Part of the current tensions between the regions is because Flanders wants to keep more of its tax revenue "at home" and resents sending transfer payments to the economically challenged Wallonia.

A Nation in Three Parts
Belgium is a nation with three distinct parts.

(Source: University of Texas)

The northern part of Belgium, Dutch-speaking Flanders, represents 58% of the population. The southern part, French-speaking Wallonia, represents 32%. There is a small German-speaking region near the German border, which joined Belgium by plebiscite after World War I. The capital, Brussels, is multilingual.

Among the population, 59% of primarily Dutch speakers can also speak French, whereas only 19% of primarily French speakers can converse in Dutch. The political system is designed to preserve these cultural and linguistic differences. There is no system of bilingual education or laws; instead of seeing work to integrate the two regions, we see them becoming increasingly separate.

The Current Crisis
The elections on June 10 gave power to the Flemish Christian Democrats. Yves Leterme, the party's leader, has been unable to form a coalition government. His party's platform was to further devolution, putting more power into the regional governments. Needless to say, the Walloons, dependent upon transfer payments from Flanders, opposed the policy direction and have failed to participate in coalition building. At the same time, there is strong support in the Flemish parties for Leterme's policy recommendations.

Tensions have increased dramatically during the past two weeks after the Flemish parties brought a bill to the parliament that would prevent French-speaking voters living in the Dutch-speaking suburbs around Brussels from voting for candidates in French-speaking precincts. Belgium courts have ruled that such exceptions violated the constitution, but Walloons expected some sort of accommodation. Instead, when the bill was presented to parliament, French-speaking lawmakers refused to participate and walked out. This has hardened positions between the two groups and threatens to further delay the formation of a government.

What Will Become of Belgium?
Recent events have raised the specter that Belgium could break apart. Polls indicate that 66% of Belgium Dutch speakers expect the country to break apart "someday." There are some difficult issues that would come with a breakup, however.

- Would a separation be "easy" like that of Czechoslovakia or "hard" like that of Kosovo? Given Belgium's position in civilized Europe, it is difficult to imagine a shooting war developing over separation, but there could be legal skirmishes over property and shared institutions. Thus, separation may be simple in concept, but the actual execution may be very difficult.

- Would the separation of Belgium, one of the founding members of the European Union, prompt other ethnic groups to press for greater autonomy and perhaps independence? Would, for example, the Basques use this separation as a precedent for removing the Basque region from Spain? Or Scotland from the United Kingdom? The European Union would likely be very concerned about the instability that could develop from such trends.

- What would be the currency outcome? Belgium is a member of the Eurozone, using the euro for its currency. If the two regions separate, would the European Central Bank accept both nations as viable enough to use the single currency, or would one or both nations be forced to reissue national currencies? What impact would the loss of Belgium have on the euro?

- Would both areas remain independent, or would they join other nations? Polls show that 45% of Dutch nationals would welcome the merger of the Netherlands and Flanders. Other polls show that 66% of French citizens living near the Belgium border would be willing to absorb Wallonia. It is possible that Belgium would simply cease to exist and the Netherlands and France would enlarge.

Of course, maybe none of this will happen. Although the linguistic divide has been growing since the 1970s, probably neither group is prepared to take the step of liquidating the state of Belgium. One major issue is that neither group would want to cede Brussels to the other. For separation to occur, this key city would likely be forced to "internationalize" — perhaps becoming like the Vatican City. This may be possible given that Brussels is the seat of the European Union and NATO. We don't expect that separation is imminent; however, tensions are rising and if a government isn't formed soon, Belgium voters may simply decide to finish a process that appears to be moving toward separation.

Ramifications

Belgium separation could affect the financial markets in three ways:

- First, if Belgium separates and at least one of the devolved states remains independent, the nature of the euro changes as one of the constituent nations has changed. It is similar to the problems that plagued the Canadian dollar when there were fears that Quebec would separate; the currency tended to weaken on concerns that the Canadian economy would be adversely affected by the loss of Quebec. Thus, separation would likely weaken the euro. It would also call into question the eventual expansion of the single currency to Eastern Europe as these nations may be more susceptible to separatist issues.

- Second, separation could encourage other separatist movements in Europe and elsewhere to consider autonomy and independence. This could increase global instability and encourage investors to hold safety instruments, such as Treasuries, and avoid confidence assets, such as equities.

- Finally, it could adversely affect investments in Europe, most directly in Belgium, as separation would raise uncertainty and likely cause investors to pull back from the country and the region until the situation is resolved. Thus, European equity markets could be adversely affected.

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This report was prepared by Bill O'Grady (currently of Confluence Investment Management LLC but published while at a prior firm, A.G. Edwards) and reflects the opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.